

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
PASSIVE DOMESTIC SMALL CAPITALIZATION
EQUITIES – EXTERNALLY MANAGED**

February 14, 2005

This Policy is effective immediately upon adoption and supersedes all previous externally managed passive domestic small capitalization equities policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Externally Managed Passive Domestic Small Capitalization Equities Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the United States equity market.

II. STRATEGIC OBJECTIVE

Capturing the returns of small capitalization stocks within the United States equity market at a low cost through passive management is the strategic objective of the Program.

The Program shall be managed to accomplish the following:

- A.** Diversify the System's domestic equity investment program by allocating a portion of the portfolio to the stocks of smaller companies.
- B.** Enhance, during a specific period, the total return of the domestic equity program.
- C.** Hedge against active member (pre-retirement) liabilities.
- D.** Consider solely the interests of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A.** The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Investment Committee delegates the responsibility for administering the passive domestic small capitalization portion of the System to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).
- B.** The **System's Investment Staff** ("the Staff") duties include, but are not limited to, the following:
1. Developing and recommending the Policy to the Investment Committee.
 2. Developing and maintaining a procedures manual, subject to periodic reviews and updates, outlining Staff operational procedures used in implementing this Policy.
 3. Implementing and adhering to the Policy.
 4. Recommending action concerning outside money management firm(s) ("Managers") retained under contract to implement the Program. The Staff shall make recommendations in accordance with the Manager Monitoring - Externally Managed Policy, regarding changes in the Manager's contractual guidelines, and any other aspect Staff considers pertinent.
 5. Reporting to the Investment Committee, as needed, about the performance of the Program. The Staff shall monitor the implementation of, and compliance with, the Policy. The Staff shall report concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing to the Investment Committee. Reports made by the Staff to the Investment Committee shall include explanations of the violations and appropriate recommendations for corrective action.
- C.** Each **Manager** is responsible for all aspects of portfolio management as set forth in each Manager's contract with the System and shall fulfill the following duties:

1. Communicate with the Staff as needed regarding investment strategy and investment results. The Manager is expected to monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.
2. Cooperate fully with the System's Staff, Custodian, and General Pension Consultant on requests for information.

D. The **General Pension Consultant** is responsible for monitoring and evaluating the Managers' performance relative to the benchmark and Policy. The General Pension Consultant shall report to the Investment Committee on a quarterly basis, in accordance with its contract.

IV. PERFORMANCE OBJECTIVE

The performance objective of the strategy is outperforming the System's target benchmark for domestic equities, the custom Wilshire 2500, during a market cycle. Additionally, the portfolio shall generate performance results through time consistent with its designated benchmark, as specified in the Investment Management Guidelines, with realized return deviation of no more than 200 basis points annually. During longer periods of time, tracking error may fall between 25 basis points and 100 basis points.

V. INVESTMENT APPROACH AND PARAMETERS

A. Approach

1. Given the large asset base that the System invests, The Program shall passively manage a portion of the small capitalization equity exposure. This structure reflects a compromise between the potential for value-added through active management and the practical limitations inherent in managing a very large pool of small capitalization assets within the liquidity limitations of the small capitalization market.

The passive portfolio shall be managed to achieve the following results:

- a. **Diversification.** A passive approach assures that the System shall achieve its goal of broad exposure to the securities included in the benchmark.

- b. Certainty of Returns. Returns from passive management shall track the benchmark with a low level of residual volatility. Therefore, the passive portfolio has a low risk of significantly under performing its benchmark.
- c. Efficiency. Deploying larger amounts of money with a passive strategy is possible.
- d. Low Cost. Management fees and transaction costs are lower for passive management than for active management.

The Managers shall construct and maintain a portfolio that is consistent with, and closely resembles, the composition and risk characteristics of the benchmark index, in accordance with the Investment Management Guidelines.

- 2. Implementation of the program shall occur through the retention of an external manager(s). External manager selection shall occur in accordance with Section V.B of this Policy.
- 3. The System shall continuously review the viability of the investment structure, with a formal review occurring at least every five years.

B. External Manager Selection

- 1. The System shall retain managers that have recognized expertise in the analysis and selection of small capitalization domestic equity securities. The managers shall be registered or appropriately exempt from registration, with the Securities and Exchange Commission.
- 2. The System shall select the managers in accordance with the System's Contract and Procurement policy.

C. Investment Parameters

- 1. The Managers shall operate under a set of specific guidelines that outlines the investment philosophies and approaches, representative portfolio characteristics, permissible and restricted securities and procedures, and performance objectives representative of its strategic role within the System's investment program and the investment

risk incurred.

2. The implementation of this program shall comply at all times with the System's investment policies, including, but not limited to the following parameters:
 - a. Statement of Derivatives Investment Policy for External Money Managers.
 - b. Proxy Voting Policies.
 - c. Manager Monitoring – Externally Managed Policy.
 - d. Manager-specific Investment Management Guidelines.

VI. BENCHMARK

The benchmark for the Passive Small Capitalization Domestic Equity Portfolio shall be the DFA Small Cap Benchmark created by Richards & Tierney. This index includes all stocks in the bottom 8% of all companies by market capitalization that trade on the NYSE, NASDAQ, and the American Stock Exchange excluding tobacco stocks as determined by Investor Responsibility Research Center (IRRC).

VII. GENERAL

- A. Terms in this policy are defined in a master glossary of terms.
- B. Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on a market value basis, as recorded by the System's custodian.

VIII. GLOSSARY OF TERMS

The Equities Glossary of Terms is referenced in the System's Master Glossary of Terms.